

04-3530.061-JCD

July 12, 2006

**IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION**

IN RE BALLY TOTAL FITNESS) Nos. 04 C 3530, 04 C 3634,
SECURITIES LITIGATION) 04 C 3713, 04 C 3783,
) 04 C 3844, 04 C 3936,
) 04 C 4697, 06 C 1437
)

MEMORANDUM OPINION

Before the court are defendants' motions to dismiss the consolidated class action complaint. For the reasons explained below, the motions are granted.

BACKGROUND

Plaintiffs have filed several related securities fraud putative class actions against Bally Total Fitness Holding Corporation ("Bally"); three of its current or former officers and directors, Lee S. Hillman, John W. Dwyer, and Paul A. Toback; and Bally's former auditor, Ernst & Young, LLP, for violations of §§ 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission (the "SEC"), 17 C.F.R. 240.10b-5. Plaintiffs allege that defendants violated federal securities laws by publicly disseminating false and misleading corporate reports, financial statements, and press releases primarily through "two related fraudulent techniques": improperly recognizing revenue

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prematurely and improperly delaying the recordation of expenses. (Consolidated Class Action Complaint ("CCAC") ¶ 5.)

We previously granted the parties' motions for consolidation of the cases for all purposes and directed that the consolidated cases be referred to as "In re Bally [Total] Fitness Securities Litigation." (Minute Order of Sept. 8, 2004.)¹ We also appointed Cosmos Investment Company, LLC ("Cosmos") as lead plaintiff (Memorandum Opinion of March 15, 2005), and appointed lead and local counsel (Minute Order of May 23, 2005). On January 3, 2006, Cosmos filed a consolidated class action complaint on behalf of a class consisting of those who purchased or acquired Bally securities during the period of August 3, 1999 through and including April 28, 2004. The complaint alleges the following facts, which are taken as true for purposes of the instant motions.

Defendant Bally is a corporation that operates hundreds of fitness centers throughout North America with approximately four million members. Bally's securities are publicly traded on the New York Stock Exchange. During the time period relevant to this action, defendant Dwyer was Bally's Chief Financial Officer ("CFO"), Executive Vice President, and a member of Bally's Board of

^{1/} The consolidated cases are as follows (abbreviating defendants to "Bally"): Petkun v. Bally, 04 C 3530; Marcano v. Bally, No. 04 C 3634; Garco Invs., LLP v. Bally, No. 04 C 3713; Salzmann v. Bally, No. 04 C 3783; Rovner v. Bally, No. 04 C 3844; Koehler v. Bally, No. 04 C 3936; Eads v. Bally, No. 04 C 4697; and Levine v. Bally, 06 C 1437.

Strougo v. Bally, No. 04 C 3864, was voluntarily dismissed on March 15, 2005, and Rosenberg v. Bally, No. 04 C 4342, was voluntarily dismissed on April 7, 2005.

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Directors (the "Board"); defendant Hillman was Chief Executive Officer, President, and Chairman of the Board until December 2002. Defendant Toback is Bally's current Chief Executive Officer, President, and Chairman of the Board. We will refer to Hillman, Dwyer, and Toback collectively, where appropriate, as the "Individual Defendants." The accounting firm Ernst & Young, LLP ("E & Y") was Bally's outside auditor until it resigned the engagement on March 31, 2004.

From August 3, 1999 through April 2004, Bally issued press releases and filed 8-K, 10-K and 10-Q forms with the SEC stating its financial results for various time periods. Some of the SEC filings contained certifications by Dwyer and Hillman, or Dwyer and Toback, pursuant to the Sarbanes-Oxley Act of 2002. In the Sarbanes-Oxley certifications, the Individual Defendants attested that they had reviewed the contents of the particular report to confirm that it did not contain any untrue statement of material fact or omit a material fact necessary to make the statements not misleading.

Plaintiffs allege that Bally's financial statements were materially false and misleading because, contrary to defendants' representations, they had not been prepared in conformity with Generally Accepted Accounting Principles (GAAP). Bally is alleged to have violated GAAP in the following ways:

- improperly recognizing membership revenue

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- deferring costs incurred in signing up members instead of recognizing membership acquisition expenses, thereby reflecting the costs as an asset
- establishing accruals for unpaid dues on inactive membership contracts instead of writing them off as uncollectible
- improperly accounting for payment obligations in relation to the acquisition of a business
- improperly classifying proceeds from the sale of a future revenue stream
- recognizing cash received in advance of the performance of personal training services as fees earned instead of as deferred revenue
- improperly separating multiple-element bundled contracts for health club services, personal training services, and nutritional products into multiple accounting units, resulting in premature revenue recognition
- failing to estimate the ultimate cost of settling self-insurance claims for workers' compensation, health and life, and general liability, thereby materially understating its liability for these claims
- improperly capitalizing costs incurred to develop internal-use software
- failing to record and assign a fair value to certain separately identifiable acquired intangible assets
- establishing a practice of amortizing goodwill over forty years when this amortization period was inconsistent with the maximum reasonable and likely duration of material benefit from the acquired goodwill
- ignoring "trigger events" and other conditions which, at various dates, indicated that the carrying amounts of fixed assets were impaired, and failing to perform any impairment analyses or recognize impairment losses
- reporting the dollar amount of uncashed checks as income instead of as escheatment liabilities;
- capitalizing advertising costs and amortizing those costs over the estimated life of the advertising campaign instead of expensing them when the first advertisement took place
- adding maintenance costs to the costs of property and equipment and then depreciating this improperly established "asset"

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- improperly deferring costs associated with start-up activities, such as rent
- failing to properly compile and record inventory on a periodic basis and failing to match appropriate costs with revenues in order to make a proper determination of the realized income
- failing to accrue obligations as of the end of each accounting period even though transactions and events giving rise to the obligations arose during the accounting period
- failing to recognize gains and losses from various foreign currency transactions that affected individual assets, liabilities, and cash flows
- failing to recognize rent expense on club leases with escalating rent obligations using the required straight-line method; failing to reflect lease incentives as reductions of rental expense over the term of the lease; and improperly reflecting tenant allowances as a reduction to property and equipment and depreciating these amounts
- reflecting deferred tax assets and valuation allowances based upon improperly-determined taxable income and without having performed a realistic and objective assessment as to whether it was more likely than not that some or all of the deferred tax asset would not be realized

(CCAC §§ 121-174.)

Plaintiffs also allege that E & Y, in its capacity as Bally's outside auditor during most of the relevant time period, played a role in the fraud. E & Y issued several unqualified audit opinions on Bally's consolidated financial statements for the years 1999-2003. Plaintiffs maintain that E & Y diverged from Generally Accepted Auditing Standards (GAAS) when auditing Bally in that it either identified and ignored flagrant multiple violations of GAAP or recklessly failed to identify these violations.

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The complaint alleges that “[t]he truth concerning [Bally’s] chronic accounting improprieties began to emerge on April 28, 2004.” (CCAC ¶ 8.) On that day, Bally issued a press release announcing that its CFO, Dwyer, had resigned “pursuant to the terms of a separation agreement” and that “[s]eparately, the Company announced” that the SEC had commenced an investigation connected to Bally’s recent restatement regarding the timing of recognition of prepaid dues.² (Id. ¶ 8 (quoting from press release).) In plaintiffs’ view, the press release “cast serious doubt on the accuracy and reliability of Bally’s financial statements, and, significantly, on the integrity of Bally’s management.” (Id. ¶ 9.)

Plaintiffs assert that in response to the April 28, 2004 announcement, the price of Bally common stock fell from \$5.40 per share on April 28 to \$4.50 per share on April 29, a 16.6% drop. In the period of ninety trading days following the April 28 disclosure, the stock reached a mean trading price of \$4.56 per share.

When Bally found out that it was being investigated by the SEC, it initiated an internal investigation of its accounting practices, spearheaded by its Audit Committee. On November 15, 2004, Bally announced that based on the internal investigation, the Audit Committee had concluded that Bally’s financial statements for

^{2/} On April 2, 2004, Bally had issued an initial restatement of previously-reported 2003 financial results. (CCAC ¶ 8 n.1.)

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the years 2000 through 2003 (including the initial restatement of 2003 that had been issued on April 2, 2004) and the first quarter of 2004 could no longer be relied upon and should be restated. Bally also announced that it would be unable to issue any financial statements for the remainder of 2004 or for 2005 until it had completed the restatements, which were expected to be issued in July 2005 (but were not actually issued until November 2005).

On February 8, 2005,³ Bally issued a press release announcing the findings of the Audit Committee. Bally announced that it was suspending the severance pay of Hillman and Dwyer (the former CEO and CFO, respectively), who, in the Audit Committee's view, "were responsible for multiple accounting errors and creating a culture within the accounting and finance groups that encouraged aggressive accounting." (CCAC ¶ 14.) Bally also stated that it had identified deficiencies in its internal controls over financial reporting.

On November 30, 2005, Bally filed a restatement that comprehensively restated its financial results for 2000, 2001, 2002, and 2003, and first reported results for 2004 and the first three quarters of 2005 (the "Restatement"). The adjustments in the Restatement resulted in an increase in previously-reported net loss of \$96.4 million for the year 2002 and a decrease in net loss of

^{3/} Plaintiffs state in their briefs that the complaint incorrectly refers to this date as February 10, 2005. (Plaintiffs' Response to E & Y's Mot. at 4 n.2, Plaintiffs' Response to Bally Defs.' Mot. at 6 n.3.)

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\$540 million for the year 2003. Bally also increased the January 1, 2002 opening accumulated stockholders' deficit by \$1.7 billion to recognize the effects of corrections in financial statements prior to 2002.

The first of these related cases was filed on May 20, 2004. The consolidated class action complaint of January 3, 2006 contains two counts. In Count I, plaintiffs allege that the defendants violated § 10(b) of the Securities Exchange Act and Rule 10b-5. Count II is a "control person" claim in which plaintiffs allege that the Individual Defendants violated § 20(a) of the Securities Exchange Act. Plaintiffs seek compensatory damages as well as attorney's fees, costs, and expenses.

Four separate motions to dismiss the consolidated class action complaint have been filed by (1) Bally and Toback; (2) Hillman; (3) Dwyer; and (4) E & Y. Those motions are now fully briefed.

DISCUSSION

Section 10(b) of the Securities Exchange Act makes it unlawful for a person "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b). Among those rules is Rule 10b-5, which "prohibits the making of any untrue statement of material fact or the omission of a material fact that would render statements made misleading in connection with the purchase

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or sale of any security." In re HealthCare Compare Corp. Sec. Litig., 75 F.3d 276, 280 (7th Cir. 1996).⁴ To prevail on a Rule 10b-5 claim, a plaintiff must establish that the defendant: (1) made a false statement or omission, (2) of material fact, (3) with scienter, (4) in connection with the purchase or sale of securities, (5) upon which the plaintiff justifiably relied, and (6) that the false statement or omission proximately caused the plaintiff's injury. Otto v. Variable Annuity Life Ins. Co., 134 F.3d 841, 851 (7th Cir. 1998).

The heightened pleading requirements of Federal Rule of Civil Procedure 9(b) apply here because plaintiffs' claims are based on securities fraud. See Sears v. Likens, 912 F.2d 889, 893 (7th Cir. 1990) ("Rule 9(b) . . . governs claims based on fraud and made pursuant to the federal securities laws."). Rule 9(b) requires plaintiffs to plead with particularity the factual bases for averments of fraud, including "the identity of the person making the misrepresentation, the time, place, and content of the misrepresentation, and the method by which the misrepresentation

^{4/} Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

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was communicated to the plaintiff." Id. (citation omitted); see also DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990) (stating that the plaintiff must plead the who, what, when, where, and how of the alleged fraud).

Plaintiffs' claims are also subject to the heightened pleading requirements of the Private Securities Litigation Reform Act ("PSLRA"), 15 U.S.C. § 78u-4 et seq.,⁵ which the Seventh Circuit recently described:

Unlike a run-of-the-mill complaint, which will survive a motion to dismiss for failure to state a claim so long as it is possible to hypothesize a set of facts, consistent with the complaint, that would entitle the plaintiff to relief, the PSLRA essentially returns the class of cases it covers to a very specific version of fact pleading--one that exceeds even the particularity requirement of [Rule] 9(b). Under the PSLRA, a securities fraud complaint must (1) "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed" and (2) "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(1), (2). In other words, plaintiffs must not only plead a violation with particularity; they must also marshal sufficient facts to convince a court at the outset that the defendants likely intended to deceive, manipulate, or defraud.

^{5/} The PSLRA "was designed to curb abuse in securities suits, particularly shareholder derivative suits in which the only goal was a windfall of attorney's fees, with no real desire to assist the corporation on whose behalf the suit was brought." Green v. Ameritrade, Inc., 279 F.3d 590, 595 (8th Cir. 2002).

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Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 594 (7th Cir. 2006) (citations and some internal quotation marks omitted).

Defendants contend that plaintiffs have failed to plead their claims with the required particularity and that plaintiffs have failed to adequately plead the elements of scienter and loss causation.

A. Scienter

To satisfy the scienter requirement of § 10(b) and Rule 10b-5, a plaintiff must demonstrate that a defendant either had the "intent to deceive, manipulate, or defraud," Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976), or a "reckless disregard for the truth of the material asserted, whether by commission or omission," Ambrosino v. Rodman & Renshaw, Inc., 972 F.2d 776, 789 (7th Cir. 1992) (internal quotation marks omitted). "[R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Sundstrand Corp. v. Sun Chem. Corp., 553 F.3d 1033, 1045 (7th Cir. 1977), cited in Makor Issues, 437 F.3d at 600.

"Congress did not, unfortunately, throw much light on what facts will suffice to create [a strong inference of scienter].

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Currently three different approaches toward the way to demonstrate the required 'strong inference' exist among the courts of appeals." Makor Issues, 437 F.3d at 601. One approach is to allow plaintiffs to state a claim by pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior. The second approach declines to adopt the "motive and opportunity" analysis and imposes a more onerous burden of pleading in great detail facts constituting strong circumstantial evidence of deliberately reckless or conscious misconduct. See id. (summarizing case law). In Makor Issues, the Seventh Circuit chose the middle ground, which neither adopts nor rejects particular methods of pleading scienter, such as alleging facts showing motive and opportunity, but instead requires plaintiffs to plead facts that together establish a strong inference of scienter. See id. "[T]he best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish such an inference. Motive and opportunity may be useful indicators, but nowhere in the statute does it say that they are either necessary or sufficient." Id.

Another concern discussed in Makor Issues is the degree of imagination we can use in deciding whether a complaint creates a strong inference of scienter. The Seventh Circuit held: "Instead of accepting only the most plausible of competing inferences as

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sufficient at the pleading stage,⁶ we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." Id. at 602.

The Seventh Circuit also held in Makor Issues that the "group pleading doctrine," pursuant to which scienter allegations made against one defendant could be imputed to all other defendants in the same action, did not survive the heightened pleading requirements of the PSLRA. See id. at 603. "While we will aggregate the allegations in the complaint to determine whether it creates a strong inference of scienter, plaintiffs must create this inference with respect to each individual defendant in multiple defendant cases." Id. (emphasis added).

Defendants contend that plaintiffs have failed to plead any particularized facts sufficient to give rise to any inference, much less the requisite strong inference, of scienter. Defendants point out that plaintiffs have failed to allege any particular "red flags" that should have warned defendants of accounting problems or any particular conversations, meetings, or documents. Moreover, the complaint fails to allege that the Individual Defendants sold

^{6/} The Court was referring to the Sixth Circuit's pronouncement in Fidel v. Farley, 392 F.3d 220, 227 (6th Cir. 2004), that the "strong inference" requirement creates a situation where plaintiffs are entitled only to the most plausible of competing inferences. The Seventh Circuit declined to express a view on whether the Sixth Circuit's approach is constitutional, but stated: "[W]e think it wiser to adopt an approach that cannot be misunderstood as a usurpation of the jury's role." Makor Issues, 437 F.3d at 602.

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any stock during the class period and thereby benefited from the allegedly inflated stock prices. Defendants also argue that the complaint is problematic because it expressly relies on the "group pleading doctrine," which was rejected in Makor Issues.⁷

In their responses⁸ to defendants' motions, plaintiffs submit that they have met their burden of pleading scienter by alleging the following, taken collectively: (1) the "admissions" in Bally's press release of February 8, 2005; (2) the characteristics of the Restatement; (3) "motive and opportunity" allegations; and (4) Bally's violation of its own internal accounting policies.⁹ We will address each category in turn and then address each of the defendants.

Plaintiffs first point to Bally's press release of February 8, 2005, which announced the findings of Bally's Audit Committee, and quote extensively in their briefs from that press release. (The press release is also attached as an exhibit to plaintiffs' briefs.) The press release included, inter alia, the following statements: there had previously been numerous accounting errors; Bally had taken "aggressively optimistic positions" on accounting

^{7/} The complaint states: "It is appropriate to treat the Individual Defendants as a group for pleading purposes" (CCAC ¶ 33.)

^{8/} Plaintiffs filed two responsive briefs to defendants' motions. One brief responds to the motions of Bally and Toback, Hillman, and Dwyer; the second brief responds to the motion of E & Y.

^{9/} Plaintiffs categorize their allegations slightly differently, but we have reorganized them to facilitate our discussion.

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policies "without a reasonable empirical basis"; Hillman and Dwyer, who had both resigned by then, had been responsible for a culture of "aggressive accounting"; Dwyer had made a "false and misleading" statement to the SEC; as a result of the findings, Hillman and Dwyer's severance pay was being discontinued; two employees (who are not defendants in this action) had engaged in unspecified "improper conduct"; E & Y had "made several errors" in its audit work; and Bally's "internal controls" had numerous deficiencies. (Plaintiffs' Response to Bally Defs.' Mot. at 6-7.)

Plaintiffs maintain that through these statements, Bally "admitted its own scienter." If that is the case, we find it curious that the complaint refers to the press release in only two paragraphs and quotes from it only in relation to the statement regarding Hillman and Dwyer creating a culture of "aggressive accounting." (CCAC ¶¶ 14-15.) Plaintiffs argue that they are permitted to allege additional facts in response to a motion to dismiss so long as those facts are consistent with the complaint's allegations. The cases they cite for this proposition, however, were not cases where fact pleading was required, as it is here.

Nevertheless, for purposes of this motion and so we do not have to revisit this issue, we will consider the complaint as incorporating the press release. We do not believe it assists the plaintiffs in raising an inference of scienter. First of all, the findings are vague and unspecific, and many of the terms, such as

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"aggressive accounting" and "aggressively optimistic," are imprecise. None of the alleged errors, aggressively optimistic positions, improper conduct, or deficiencies in controls constitute particularized allegations. And contrary to plaintiffs' argument, the fact that Bally acknowledged that false statements were made is not equivalent to admitting scienter. A false statement is one element of a securities fraud claim; scienter is a wholly separate element. The Audit Committee's findings are essentially of negligence, but not scienter. It is important to remember that simple negligence and even "inexcusable negligence" does not amount to scienter. What is required to be shown is an extreme departure from the standards of ordinary care. The findings do not rise to this level. Another reason why the press release does not support an inference of scienter is that the findings are simply hindsight conclusions. They do not assist in determining the state of mind behind the misstatements at the time they were made. See generally DiLeo, 901 F.2d at 628 ("There is no 'fraud by hindsight'"); Sundstrand, 553 F.2d at 1045 n.19 ("[T]he circumstances must be viewed in their contemporaneous configuration rather than in the blazing light of hindsight."); Davis v. SPSS, Inc., 385 F. Supp. 2d 697, 714 (N.D. Ill. 2005) ("Permutations of 'fraud by hindsight' do not create an inference, much less a strong inference, of scienter.").

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The second factor relied on by plaintiffs is the Restatement and its characteristics. Plaintiffs assert that the Restatement "totaled 438% of the aggregate pre-restatement net income" and that we can infer scienter from the magnitude of the Restatement, combined with the high number and repetitiveness of the GAAP violations and the simplicity of the accounting principles that were violated. (Plaintiffs' Response to Bally Defs.' Mot. at 14-16.)

The Seventh Circuit has observed that even a very large restatement is not itself evidence of scienter:

Four billion dollars is a big number, but even a large column of big numbers need not add up to fraud.

. . .
The story . . . is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud.

DiLeo, 901 F.2d at 627 (citing, inter alia, Goldberg v. Household Bank, F.S.B., 890 F.2d 965, 967 (7th Cir. 1989), which noted: "Restatements of earnings are common."). See also Fidel v. Farley, 392 F.3d 220, 231 (6th Cir. 2004) ("Allowing an inference of scienter based on the magnitude of fraud . . . would . . . allow the court to engage in speculation and hindsight, both of which are counter to the PSLRA's mandates."); Davis, 385 F. Supp. 2d at 713

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("Restatements establish that misleading statements were made, but . . . provid[e] no assistance in determining the intent behind the misstatements."); Chu v. Sabratek Corp., 100 F. Supp. 2d 815, 824 (N.D. Ill. 2000) ("A company's overstatement of earnings, revenues, or assets in violation of GAAP does not itself establish scienter.").

We are not prepared to say that the magnitude of a restatement could never contribute to an inference of scienter. But this is not such a case, especially considering that the SEC filings and press releases at issue did not consistently overstate revenues and income or consistently understate losses. Rather, the revenue for some quarters was at times understated and losses for some quarters were at times overstated during the class period. On these facts, it is clear that significant mistakes were made, but we cannot infer scienter. The same can be said for plaintiffs' argument that the number and repetitiveness of the GAAP violations and the purported simplicity of the pertinent accounting principles support an inference of scienter. These "characteristics" of the Restatement are simply another way of saying that multiple accounting errors were made, but they are not facts tending to show that defendants acted with the required intent.

Another category of allegations relied upon by plaintiffs can be deemed the "motive and opportunity" allegations. One allegation is that the Individual Defendants had the opportunity to commit

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fraud based on their positions in the company and their access to financial information. Scierter, however, may not rest on the inference that defendants must have been aware of a misstatement based simply on their positions within the company. See Davis, 385 F. Supp. 2d at 713-14 (quoting Johnson v. Tellabs, Inc., 262 F. Supp. 2d 937, 957 (N.D. Ill. 2003) and Abrams v. Baker Hughes Inc., 292 F.3d 424, 432 (5th Cir. 2002)). Plaintiffs assert that they have not pled scierter based merely on the Individual Defendants' positions in the company, but also on the Individual Defendants' personal responsibility for the accounting errors and aggressive accounting as well as their signed Sarbanes-Oxley certifications attesting that they had evaluated the company's internal controls. As noted above in relation to the Audit Committee's findings, the assertion that the Individual Defendants were personally responsible for the errors and "aggressive accounting" is conclusory; there are no facts alleged to bolster this allegation. Nor are any particular facts alleged as to what internal controls the Individual Defendants were familiar with and how these related to the accounting misstatements.

Plaintiffs also emphasize their allegation that the accounting misstatements were related to Bally's "core business" and contend that we can therefore infer scierter because senior executives are presumed to know facts critical to a company's core operations. They also assert that we can infer scierter from Hillman and

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Dwyer's backgrounds in accounting. These arguments are attempts at an end-run around the requirement that plaintiffs set forth particularized facts to suggest that defendants acted knowingly or recklessly. Plaintiffs cannot rely on a "must have known" theory. See Friedman v. Rayovac Corp., 295 F. Supp. 2d 957, 995 (W.D. Wis. 2003) (stating that the inference that officers and directors are aware of the corporation's "core business matters" relies on a "must have known" logic that the Seventh Circuit has rejected even under Rule 9(b)) (citing DiLeo, 901 F.2d at 629).

Plaintiffs' "motive" allegations are twofold: (1) defendants were motivated to misstate Bally's financial results in order to obtain financing, refinance outstanding debt, and complete acquisitions; and (2) the Individual Defendants were motivated to misstate financial results in order to earn bonuses contingent on financial performance and stock awards pursuant to incentive plans. We will first address these allegations in relation to the Individual Defendants and will then return to the first category of allegations in relation to Bally.¹⁰

Neither category of "motive" allegations is evidence of scienter as to the Individual Defendants. "Motives that are generally possessed by most corporate directors and officers do not suffice; instead, plaintiffs must assert a concrete and personal benefit to the individual defendants resulting from the fraud."

^{10/} These allegations have no relevance to the scienter of E & Y.

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Kalnit v. Eichler, 264 F.3d 131, 139 (2d Cir. 2001). We cannot infer scienter on the part of the Individual Defendants merely from their general desire for their corporation to appear profitable and thereby obtain financing and engage in mergers or acquisitions. See id.; Davis, 385 F. Supp. 2d at 714 (increased company buying power afforded by an overvalued stock is a broad motive that easily applies to a majority of corporate executives and is insufficient to establish scienter); Malin v. IVAX Corp., 17 F. Supp. 2d 1345, 1361 (S.D. Fla. 1998) (motive of maintaining a stock price in order to facilitate mergers and acquisitions "can be ascribed to virtually all corporate officers and directors" and thus fails to raise a strong inference of scienter).

Regarding the motive to earn bonuses and awards, we agree with the view of numerous courts that these allegations are too common among corporations and their officers to be considered evidence of scienter. See, e.g., Abrams, 292 F.3d at 434 ("Incentive compensation can hardly be the basis on which an allegation of fraud is predicated. . . . It does not follow that because executives have components of their compensation keyed to performance, one can infer fraudulent intent."); Sandmire v. Alliant Energy Corp., 296 F. Supp. 2d 950, 959 (W.D. Wis. 2003) ("Motivations to keep stock prices high to increase personal salaries and to boost financial standing to gain regulatory approval are so common among corporations and their officers that

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allowing them to satisfy the scienter allegation requirement would be tantamount to eliminating it.""). As the court in Davis observed:

The complaint alleges that [defendants] shared certain motives to inflate the stock price—increased compensation for the officers, an ability to meet analyst expectations, and increased company buying power afforded by an overvalued stock. Just as these broad motives apply to [defendants], they easily apply to a majority of corporate executives. The desire to increase the value of a company and attain the benefits that result, such as meeting analyst expectations and reaping higher compensation, are basic motivations not only of fraud, but of running a successful corporation. Were courts to accept these motives as sufficient to establish scienter, most corporate executives would be subject to such allegations, and the heightened pleading requirements for these claims would be meaningless.

Davis, 385 F. Supp. 2d at 714.

As for defendant Bally, some courts (largely in the Eastern District of Pennsylvania) have held that stock-based acquisitions that occurred at the time of alleged misrepresentations can support an inference of scienter in some circumstances. See, e.g., In re NUI Sec. Litig., 314 F. Supp. 2d 388, 412 (D.N.J. 2004); Marra v. Tel-Save Holdings, Inc., No. Master File 98-3145, 1999 WL 317103, at *8-10 (E.D. Pa. May 18, 1999). We do not believe that these allegations give rise to a strong inference of scienter here. It is not alleged that the two acquisitions that were completed during the class period were strictly for stock only, as is the situation in most of the cases where such transactions have been held to give rise to an inference of scienter. Moreover, there are no

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allegations that any particular financial results were misstated in order to effectuate any particular acquisition. Instead, plaintiffs allege generally that defendants were motivated to misstate results in order to artificially inflate Bally stock, and that defendants then "took advantage of th[e] artificial inflation" to obtain financing and effectuate acquisitions. (CCAC ¶ 272.) These allegations, at most, give rise to only a very weak inference of scienter on the part of Bally.

A final allegation on which plaintiffs rely in support of scienter is that Bally violated its own internal accounting policies. This allegation is similar to the allegations of GAAP violations in that it only goes toward establishing that misstatements were made. Allegations that GAAP or Bally's internal accounting policies were violated do not establish that the misstatements were made with the requisite intent. See In re BISYS Sec. Litig., 397 F. Supp. 2d 430, 448 (S.D.N.Y. 2005).

So, where do these allegations leave us with respect to each defendant? We will begin with the Individual Defendants--Hillman, Dwyer, and Toback. None of the allegations discussed supra have raised a strong inference of scienter with respect to them. In addition, there are no allegations of circumstances suggestive of scienter, such as large insider stock sales or specific meetings during which particular financial representations were discussed. Plaintiffs emphasize that we have to consider the allegations in

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their totality. This is indeed the correct standard, see Makor Issues, 437 F.3d at 603 (“[W]e will aggregate the allegations in the complaint to determine whether it creates a strong inference of scienter”), and it is the one that we are employing. Nonetheless, even under this standard, plaintiffs’ allegations fall far short of adequately pleading scienter with respect to the Individual Defendants. The complaint relies largely on conclusory allegations, speculation, and a “must have known” approach. Plaintiffs have simply failed to allege with particularity facts giving rise to a strong inference that Hillman, Dwyer, or Toback acted with the required intent or recklessness.¹¹

Plaintiffs contend, without explanation, that even if the complaint fails to allege scienter against the Individual Defendants, it still sufficiently alleges scienter against Bally. (Plaintiffs’ Response to Bally Defs.’ Mots. at 27 n.14.) Plaintiffs argue that scienter on Bally’s part can be alleged based on the “collective knowledge of its employees.” (Id. at 12.) We disagree. The Seventh Circuit has expressed doubt about an “independent corporate scienter theory.” See Caterpillar, Inc. v. Great Am. Ins. Co., 62 F.3d 955, 963 (7th Cir. 1995); see also Higginbotham v. Baxter Int’l, Inc., Nos. 04 C 4909, 04 C 7906, 2005

^{11/} We note that Hillman also argues that he is not responsible for statements made after his retirement on December 11, 2002. Plaintiffs concede that Hillman is not responsible for any statements made after his retirement. (Plaintiffs’ Response to Bally Defs.’ Mot. at 25 n.10.)

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WL 1272271, at *8 (N.D. Ill. May 25, 2005) (rejecting the theory and noting that the Fifth Circuit and the Ninth Circuit have also rejected it). "A corporation can only 'know' those things known by persons acting on its behalf." Ong ex rel. Ong IRA v. Sears, Roebuck & Co., 388 F. Supp. 2d 871, 901 n.19 (N.D. Ill. 2004). Plaintiffs have failed to allege facts giving rise to a strong inference that anyone acting for Bally had the requisite state of mind, let alone the Individual Defendants. In addition, as stated supra, Bally's acquisitions that were partly paid for in stock give rise to only a very weak inference of scienter. In any event, even if we accepted plaintiffs' argument that "collective knowledge" allegations are sufficient, there is virtually nothing in the complaint suggesting with particularity what that "collective knowledge" was.

As for E & Y, it was Bally's outside auditor, and as applied to outside auditors, "recklessness means that the accounting firm practices amounted to no audit at all, or to an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." Chu, 100 F. Supp. 2d at 823 (internal quotation marks omitted). E & Y argues that the section of the complaint setting forth plaintiffs' principal scienter allegations fails to

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state any facts regarding E & Y and that the complaint fails to point to any "red flags" suggesting recklessness.

Plaintiffs first contend that we can infer scienter from the fact that the press release announcing the Audit Committee's findings stated that Bally believed that E & Y had made several errors in the course of its auditing work. (CCAC ¶ 16.) In plaintiffs' view, they are "entitled to an inference that the press release reveals conduct by E & Y that was at least reckless, if not fraudulent." (Plaintiffs' Response to E & Y's Mot. at 9.) Plaintiffs are incorrect. As discussed supra, possible accounting errors alone do not raise an inference of scienter. See, e.g., Fidel, 392 F.3d at 231 (holding that a subsequent revelation of the falsity of previous statements does not imply scienter by an outside auditor); In re Ikon Office Solutions, Inc., 277 F.3d 658, 673 (3d Cir. 2002) ("[T]he discovery of discrete errors after subjecting an audit to piercing scrutiny post-hoc does not, standing alone, support a finding of intentional deceit or of recklessness.").

Aside from allegations about the characteristics of the restatement and Bally's violation of its internal accounting policies, which we have discussed and rejected supra as sufficient bases for an inference of scienter, the only other argument proffered by plaintiffs regarding E & Y's scienter is that E & Y was "indifferent" to red flags during its audits. (Plaintiffs'

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Response to E & Y's Mot. at 10-14.) In their response brief, plaintiffs list twelve red flags that "should have prompted E & Y to exercise greater professional skepticism during its audits." (Id. at 12-14.) The problem is that plaintiffs fail to describe these red flags in the complaint. Plaintiffs cite cases for the proposition that we may consider facts alleged in their brief if those facts are consistent with the complaint's allegations, but those cases are inapposite because they involved notice pleading, not fact pleading as required by the PSLRA.

For the sake of judicial economy, however, we will consider the twelve "red flag" items listed in plaintiffs' brief as if they had been included in the complaint.¹² Although allegations of obvious "red flags" or warning signs that financial reports are misstated can give rise to a strong inference of scienter in some circumstances, see Chu, 100 F. Supp. 2d at 824, plaintiffs' allegations are insufficient to raise a strong inference that E & Y acted with scienter. Plaintiffs' "red flags" are largely reconstituted versions of their allegations couched in the context of the Audit Standards of the American Institute of Certified Public Accountants. Four items deal with what was "revealed" in the Audit Committee's investigation. The Audit Committee's

^{12/} Plaintiffs have requested leave to amend the complaint in the event that defendants' motions are granted. Plaintiffs would undoubtedly amend the complaint to include the "red flag" allegations, and the scienter issue would arise again. Better to resolve it sooner than later and avoid duplication of efforts.

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findings involve hindsight; they do not shed light on what E & Y knew at the time of the audits. Therefore, they do not constitute red flags relevant to scienter. See, e.g., Davis, 385 F. Supp. 2d at 713-14 (red flags cannot arise out of later discoveries).

None of the remaining items raises a strong inference of scienter. Five items are problematic because they are not based on facts that are actually alleged. Plaintiffs assert that the following situations constitute "red flags": where "significant portions" of management's compensation are contingent upon achieving aggressive financial targets; where management has "significant" financial interests in the entity; where a company "needs" to obtain additional debt or equity to stay competitive; where a company has an "active" merger or acquisition calendar; and where a company has "unusually rapid growth or profitability." Plaintiffs have not alleged, though, that Bally's management had incentives or financial interests that were "significant" in that they were much larger than executives at comparable entities. Nor have plaintiffs alleged that Bally needed to obtain the financing it obtained or complete the acquisitions that it did in order to stay competitive, or that Bally's merger calendar was more active than comparable entities, or that Bally had unusually rapid growth compared to other companies. It is not evident that any of these five red flags actually existed on the facts that have been alleged.

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The three remaining purported "red flag" items are too weak to raise a strong inference of scienter. One is management's failure "to correct known reportable conditions on a timely basis." (Plaintiffs' Response to E & Y's Mot. at 14.) Plaintiffs contend that E & Y stated in 2004 that it had been aware of material weakness in "internal accounting control" for the years 2001-2003 and took that into account in performing its audits. We do not believe that it follows from this allegation that there was a failure to correct a "known reportable condition" on a timely basis. It is not even clear what constitutes a "known reportable condition."

The final two items are not even characterized by plaintiffs themselves as red flags. One is that Bally inadequately disclosed its accounting policies and therefore E & Y should have been alerted to the risk of fraud. The other is that each of the Individual Defendants worked for E & Y prior to joining Bally and that therefore E & Y should have exercised "increased audit skepticism." These items do not strike us as red flags; rather, they are risk factors. "[S]o-called 'red flags', which should be deemed to have put a defendant on notice of alleged improprieties, must be closer to 'smoking guns' than mere warning signs." Nappier v. Pricewaterhouse Coopers LLP, 227 F. Supp. 2d 263, 278 (D.N.J. 2002) (citation and some internal quotation marks omitted). Plaintiffs have failed to identify any true red flags, which are

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"specific, highly suspicious" facts or circumstances available to E & Y at the time of its audits. Riggs Partners, LLC v. Hub Group, Inc., No. 02 C 1188, 2002 WL 31415721, at *9 (N.D. Ill. Oct. 25, 2002). E & Y argues that plaintiffs have attempted to "cherry-pick a handful of very generalized risk factors, label them as 'red flags,' and stitch them together to show scienter." (E & Y's Reply at 13.) We agree. Plaintiffs have failed to allege facts tending to show that E & Y acted with the requisite scienter.

Because plaintiffs have failed to allege particularized facts sufficient to give rise to a strong inference that any of the defendants acted with the requisite intent or recklessness, Count I of the consolidated class action complaint, the § 10(b) claim, will be dismissed. Count II, the § 20(a) "control person" claim against the Individual Defendants, will also be dismissed because if there is no actionable underlying violation of the securities laws, there can be no control person liability. See Sequel Capital, LLC v. Rothman, No. 03 C 678, 2003 WL 22757758, at *17 (N.D. Ill. Nov. 20, 2003); In re Allscripts, Inc. Sec. Litig., No. 00 C 6796, 2001 WL 743411, at *12 (N.D. Ill. June 29, 2001).

Plaintiffs have requested leave to amend the complaint in the event of a dismissal. Plaintiffs will be granted leave to amend; therefore, the dismissal will be without prejudice.

B. Loss Causation

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We could have ended our discussion by stating that it is unnecessary to address defendants' loss causation arguments because we are dismissing on scienter grounds. But plaintiffs have requested, and we will grant, leave to amend the complaint. In light of the possibility of another motion to dismiss, it is useful to take up the loss causation issue now.

Plaintiffs suing under the PSLRA must plead and prove that the defendant's purported fraudulent statement or omission was the cause of their loss. See 15 U.S.C. § 78u-4(b)(4); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 347 (2005). Pursuant to Dura, the complaint must provide defendants "with some indication of the loss and the causal connection that" plaintiffs have in mind. Id. The complaint in Dura alleged that the price of the stock plaintiffs had purchased was inflated because of defendants' misstatements, but not that the share price had fallen after the truth became known. The Supreme Court held that the complaint was insufficient because an inflated purchase price does not itself constitute or proximately cause economic loss. Id.

Here, as in Dura, it is alleged in the complaint that as a result of defendants' false and misleading statements, Bally stock traded at artificially inflated prices during the class period. (CCAC ¶¶ 274-79.) But what it also alleges distinguishes this case from Dura: that when the truth became known by virtue of the April 28, 2004 announcement, the price of Bally stock "fell

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precipitously" and, as a result, plaintiffs suffered economic loss. (CCAC ¶¶ 280-81.)

Defendants maintain that plaintiffs have failed to plead loss causation because the "truth" actually became known in an earlier announcement indicating that Bally was planning on issuing a restatement of certain financial results. Defendants also argue that the price of Bally stock had already greatly declined over the course of the class period and thus the announcement was not the cause of plaintiffs' loss. Defendants frame their position as a Dura argument, but in reality it goes to the merits of plaintiffs' case. The essence of defendants' arguments is that plaintiffs cannot prove loss causation. But that is not an appropriate consideration on a motion to dismiss. It is axiomatic that on a motion to dismiss, we accept as true all factual allegations in the complaint. See Hentosh v. Herman M. Finch Univ. of Health Sciences, 167 F.3d 1170, 1173 (7th Cir. 1999). Plaintiffs have sufficiently alleged loss causation in accord with Dura, and that is all that is required of them at this juncture.

CONCLUSION

For the foregoing reasons, the following motions to dismiss the consolidated class action complaint are granted: (1) the motion of Lee S. Hillman; (2) the motion of John W. Dwyer; (3) the motion of Bally Total Fitness Holding Corporation and Paul A. Toback; and

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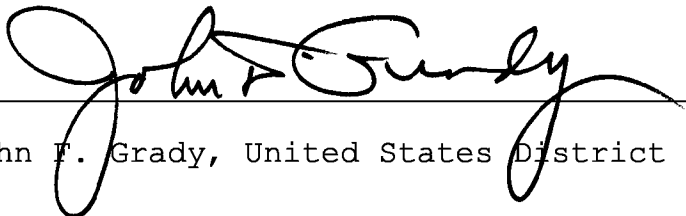
(4) the motion of Ernst & Young, LLP. The consolidated class action complaint is dismissed without prejudice.

Plaintiffs may file an amended consolidated class action complaint by August 14, 2006.

A status hearing is set for September 13, 2006, at 10:00 a.m.

DATE: July 12, 2006

ENTER:



John F. Grady, United States District Judge